The Actuarial Profession
making financial sense of the future

GIRO Conference

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UK Tax Legislation for GI Reserves

Working Party: David Hindley, Dix Roberts and Martin White

HMRC: Victor Baker

Agenda

- Tax history of insurance provisioning (Victor Baker, HMRC)
- Brief summary of the new rules
- Key points to note
- The $64,000 question
- Application at Lloyd's
- Other questions

Tax history of insurance provisioning - (1)

- Bone of contention between insurance industry and IR (now HMRC) for many years - papers going back to at least 1940
- Industry suggested unlikely to overprovision for tax purposes
- Historical IR scepticism
- Focus of insurance accounting on sufficiency
- Owen v Southern Railway, 36TC602 – Lord Radcliffe – “sufficiently reliable”

Tax history of insurance provisioning – (2)

- Lloyd's tax legislation used to contain a 'fair and reasonable' rule – s177(2)FA 1993
- 'Fair and reasonable' interpreted broadly by City General Commissioners in 1999 appeal involving the Lloyd's legislation – again the emphasis was on prudence & not discounting
- Decision then was to seek a strong legislative solution rather than challenge through the courts

Tax history of insurance provisioning – (3)

- S107 FA00 and related regulations gave rise to copious complex computations – and weaknesses addressed by amendment
- Not widely liked – except for the flexibility introduced by the disclaimer
- But this was expensive for Exchequer
- Solution – repeal s107, effective for 2007, subject to transitional disclaimer rule
- But what should be the replacement?

Tax history of insurance provisioning – (4)

- First thought (largely based on March 2006 HMT/FSA paper on Solvency II) was to specify DBE + explicit risk margin
- Not popular with insurers
- Various alternatives considered – Australian 75th percentile approach; fixed risk margin
- Recognising approach of Solvency II/ IFRS Φ II settled for approach which requires provision to reflect “skilled opinion” & “not excessive” (or simple UDBE)

Summary of the new rules

- Tax based on Technical provisions in accounts, if….
- ….Insurer confirms that claims reserves element is not excessive…
- ….and confirmation based on “actuarial” opinion

- Otherwise, HMRC have right to require insurer to use Undiscounted best estimate

Key points to note

- HMRC developing “outlier” tests.
- Actuarial Opinion only on earned subset of technical provisions.
- In theory, can use lower figure if accompanied by actuarial opinion.
- Can include ULAE (and bad debt?)
- Opinion based on facts at date accounts established, but no need to provide until later.
- Fallback is undiscounted, but for opinion, if reserves already discounted then should use that.
- No definition of “not excessive”…..

The $64,000 question

- When is a reserve “not excessive”?
- HMRC allow “reasonable” margin
- You know it when you see it
- But how do you “prove” it?
- Impact of management vs actuarial roles
- Consider potential for investment income?
- Three examples of approach
- Assume Best Estimate + Margin

Approach 1- Use prior experience

- E.g Consider volatility of prior year ultimate earned loss ratios
- Derive reasonable “deviation” from average outcome
- Compare with margin above best estimate

Approach 2 - Stress and Scenario

- Review all areas of risk
- Identify major sources and quantify plausible adverse outcome
- Can include selecting alternative individual assumptions used in deriving BE
- Add all these up and compare with margin above Best Estimate
- Margin should be <<< Total adverse outcome

Approach 3 - Stochastic

- Use stochastic model (e.g. simulation)
- Derive full distribution of future claims outgo
- Compare Booked reserve against distribution
- Determine if at “reasonable” point in distribution
- NB: Earlier rules used 75th percentile
- May already be done in ICA work

Application at Lloyd's

- Calculations done at Syndicate level; Tax actually paid at Member level
- Only applied to closing or 36m+ years
- Only earned reserves
- Likely to need separate SAO and report?
- Interaction with Solvency SAO and ICA "proof" of margin over Best Estimate

Other questions

- What Standards are needed?
- Do we need to worry about consistency between different actuaries?
- Do we need benchmarks for “excessiveness”?
- Should we turn our paper into an “IAN”?
- What further work is needed?
- Share experiences after year-end?